Chapter 2

# The Economics of the Third Sector

## Toward a More Comprehensive Approach[1]

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### INTRODUCTION

Several studies (Ciriec, 2000; Salamon & Anheier, 1994) have documented the growth, during the 1980s and the 1990s in the number of nonprofit organizations, in their employment share, and in their revenue. In several countries the nonprofit sector outperformed both the public and the private for-profit sector.

Another important aspect of the recent evolution has been the shift of a growing number of old and new nonprofit organizations toward a more productive and entrepreneurial stance. This shift has assumed different patterns in different countries, depending on the role previously played by the sector, its size, and its relationships with the public sector (mainly with the public welfare system).

In the United States, where nonprofit organizations already had an established and recognized productive role, this shift has displayed "a pattern of growing commercialism" (Weisbrod, 1998a). Nonprofits are more actively market oriented and seek out additional revenue sources by, for example,

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charging user fees on mission-related output, establishing new ancillary activities, and forming joint ventures with for-profit companies.

In European countries, the nonprofit sector has traditionally been less developed and recognized, more dependent on public policies, and advocacy oriented. The recent shift has been more toward a stable, continuous, and to some extent autonomous production both of social services and of other goods and services with the aim to integrate disadvantaged people into work. These activities are often, albeit not always, financed out of public resources. However, many of the services provided, or the methods of their delivery, are innovative, especially when compared with existing provision, both public and traditional nonprofit.[2]

Many elements of this change in behavior by nonprofit organizations can be highlighted by comparative analysis, starting with one of the most important of them: the differentiation of legal, institutional, and organizational forms.

While the U.S. legal framework has not changed, and differentiation mainly concerns the goals and the degree of the distributional mission[3] of organizations with different ideological commitments and operating in different sectors, in Europe the process has been more complex and profound. Most of the recently established nonprofit organizations do not take the incorporation form of foundations, or of other nonproprietary forms mainly or solely characterized by the distribution constraint; they have instead been incorporated as either associations or cooperatives. Both of these are proprietary organizations, sometimes owned by volunteers, but often by consumers or workers, and the nonprofit distribution constraint is not always their main institutional characteristic.

Traditionally, cooperatives did not engage in the production of social and welfare services, and associations carried out advocacy functions rather than productive activities. The legal status of both institutional forms changed during the 1990s in many European countries so that they could provide social services. Several kinds of "social cooperatives" or "cooperatives for social or collective purposes" were created, and at the same time the productive nature of associations was strengthened.[4] The cooperatives and associations that have now emerged from this process are similar in many respects: Cooperatives are guided by more public and less mutual aims, and associations are more entrepreneurial and productive in their behavior. Compared with traditional nonprofits, these new organizations rely much more heavily on the broader representation of stakeholder interests and on participative and democratic management than they do on the traditional nondistribution constraint.

In the light of this differentiation within and among European countries, the simple dichotomy between organizations allowed to distribute profit and those that are not, so widely used in the economic literature, does not suffice to explain the existence, roles, and evolution of the nonprofit sector.

A more general theoretical approach is required to understand these new phenomena. This approach should be able to explain the following: the plurality of roles performed by third sector organizations (advocacy for a particular group of citizens or for certain rights; redistribution of resources among individuals, groups, or activities; stable and continuous production of social and collective services); shifts from one role to another, and especially the recent shift toward more productive and entrepreneurial behavior; and the coexistence of a variety of organizational and legal forms characterized by different goals and constraints.

In our view, this more general approach can be developed by adopting the institutional approach to the study of organizations, but by taking into account suggestions that have been hitherto undervalued, integrating them with non-standard hypotheses on economic agents' behavior. Full understanding of the third sector and of its recent evolution requires us first to abandon an approach that considers, at least in theory, nonprofit organizations as able to compete in every market, and the adoption instead of the more realistic assumption that they are best suited, mainly or solely, to the provision of personal and community care services.[5] Second, it requires a more general definition of third sector organizations, one sufficiently flexible to include all their various roles and the diverse institutional features that they assume in different countries. This definition must be based, not on just one simple constraint, but on a more open set of characteristics including declared organizational goals, and the consistency among goals, legal constraints, and proprietary structure. Third, it requires us to relax the hypothesis that the economic agents, which interact with third sector organizations are by definition self-interested and opportunistic, and to instead assume the hypothesis that agents may have heterogeneous and complex utility functions. In other words, we must shift the focus from the role of the nondistribution or other constraints to the importance of the agents and the behavior of organization owners.

Taking into account these three analytical steps, our suggestion is to define third sector organizations as "incentive structures" which use a variety of different incentive mixes to induce the groups of agents involved (donors, volunteers, but also workers and managers) to behave consistently with the organizational goal. This goal may vary according to the importance of the distributional mission and the specific market failure that the organization must deal with. The incentive structures of third sector organizations, however, are different from those that prevail not only in for-profit and public providers but also among nonprofit organizations with different goals, proprietary structures, and institutional forms.

The chapter is organized as follows. The next section shows the shortcomings of theories based on the nonprofit distribution constraint. The third section highlights the distinctive features of the markets in which third sector

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